(5797A)

DCI Congressional Briefing:

World Economic Outlook

Among the many foreign economic issues that will be of interest in 1985, three areas deserve particular attention.

-- Trends in LDC debtor countries as we gradually move away from the crisis atmosphere of debt rescheduling to the pressures of economic reform.

-- The impact of a possible decline in OPEC oil prices on our allies.

-- And the seemingly perennial issue of our trade relations with Japan.

In addition, the striking economic changes being implemented in China must be mentioned. The world's most populous country has changed economic course and we will be monitoring its progress and assessing the implications in 1985 and beyond.

Economic Challenges for Third World Debtors

Last year was a turning point for the economies of the Third World debtor countries. Exports of goods and services from these countries started to climb, rising some 6 percent. The crisis atmosphere of debt negotiations subsided somewhat. Mexico, Venezuela and Ecuador obtained multiyear debt restructuring agreements, Brazil is heading towards an agreement, and Argentina and the Philippines came to terms with the IMF. Other agreements will, of course, be needed, and there remains substantial risk that political or economic problems could alter the

essentially favorable trends of 1984. These downside risks aside, our focus in 1985 is the legacy of the debt crisis and the ability of debtor governments to withstand popular criticism of austerity measures.

-- Imports and living standards in the LDCs are depressed; their imports are down 30 percent since 1981 and, in Latin America, per capita output has fallen 12 percent in 3 years.

-- Reflecting these underlying pressures, inflation has turned up substantially with several countries experiencing triple digit inflation.

Even if external economic conditions remain favorable for continued growth of exports, many debtors apparently face years of austerity. The conditions will make political problems more difficult to resolve and contribute to major political upsets such as the fragmentation of political power in Mexico and the growth of leftwing violence in Chile.

We also have to watch these countries closely to see how they are responding in developing domestically-oriented growth programs to improve living standards absent the $20 - 30 billion in annual commercial bank lending that helped fuel prosperity in the 1970s. Some structural changes are underway and we can detect a healthy movement toward less government intervention and more reliance on free enterprise in some countries. Nevertheless, they have a long way to go.

-- LDC savings rates are now below those that existed in the 1970s and increases in domestic savings will be needed to fund investment.

-- Measures must also be taken to allow foreign firms greater access to invest.

Some Implications of a Decline in Oil Prices

This year may also prove to be a watershed for the OPEC cartel. OPEC is having increasing difficulty marketing its oil at current prices. With the cartel's output now less than 16 million b/d, global oil prices are increasingly being influenced by the prices charged for oil in the spot market or sold under contract from the North Sea and West Texas. No one can say how far oil prices will fall should OPEC fail to hold the line, but many analysts believe that a decline of anywhere from $5 to $10 per barrel is possible.

There would certainly be much benefit in a major decline in oil prices; most of the world's $1 trillion plus annual energy bill is tied to oil. A decline in the import portion of this bill would give a fiscal boost to the Western economies and allow them to broaden their gains in the current recovery. This would be particularly important in Western Europe where governments would receive maneuvering room to battle high unemployment without having to eliminate their programs for budget austerity.

There is also a downside to an oil price decline, however.

- In the United Kingdom, the weakness of the pound related at least in part to oil prices has already caused the government to adopt some restrictive economic measures.
- Elsewhere in Europe, decisions to develop expensive offshore Norwegian gas as the major alternative to increased Soviet supplies in the 1990s would likely be sidetracked.
- In the Middle East, the financial blows would fall most heavily on the more moderate Arab states and, from there, trickle down

in the form of reduced aid to those moderate countries they support.

-- Closer to home, Mexico's financial recovery program would suffer a serious blow.

Trade Problems with Japan

As to our trade relations with Japan, for over 15 years we have discussed with the Japanese what we feel is inequitable treatment and insular behavior. Despite these discussions, Japanese markets remain essentially closed to many foreign goods.

-- Japan imports less than 15 percent of the manufactured goods sold domestically, roughly half the shares of manufactures imported by the United States and European Community.

-- Barriers still remain in areas as diverse as agriculture and communications.

-- Firms in the service sector such as banking and law are not accorded equal treatment with national firms.

This year promises to be a difficult one for our relationship in part because Japan's global surplus on goods and services is expected to exceed the 1984 total of $34 billion. Also, we sense a stiffening in Japanese attitudes on reaching new trade bargains despite the promises and, we believe, well meaning intentions of Prime Minister Nakasone.

We usually focus on Japanese behavior in individual trade sectors and products. I believe that the problem also relates to Japan's overall attitude toward development which places a priority on industrial expansion at the expense of living standards. The failure of Japanese consumers to increase their spending in line with the country's growing prosperity has foreign implications.

-- Lagging growth in consumer spending keeps Japan's savings rate (now 20 percent for households and 30 percent overall) from declining in line with the slowdown in investment as the country moves away from capital-intensive heavy industry.

-- This forces an outflow of capital that depresses the yen and increases Japan's trade competitiveness.

-- Favoring industrial over consumer growth also provides impetus to protect key high-tech industries such as computers and communications equipment including satellites.

-- Over the longer run, the existence of the savings surplus puts continuing pressure on Japan to foster new domestic investment--an export-oriented defense industry is a possible new target for the late 1980s.